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Agenda Item 4a

June 14, 2011

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: Assembly Bill 1184 (Gatto) – As Amended 04/25/11 Contracting Agency Liability for Excessive Compensation and Closure of the Replacement Benefits Plan for New Employees

II. PROGRAM: Legislation

III. RECOMMENDATION: Oppose, unless amended

The scope of this bill should be limited to closing the Replacement Benefits Program to new members.

IV. ANALYSIS:

Summary

Assembly Bill (AB) 1184 would require the contracting agency from which a non-represented California Public Employees Retirement System (CalPERS) member retires, or otherwise has his or her final compensation calculated, to pay that portion of the liability for creditable service performed for a prior contracting agency that exceeds 115 percent of the last salary paid by that agency, as adjusted for actuarially assumed salary increases. It would also prohibit the Board of Administration (Board) from administering an Internal Revenue Code (IRC) Section 415 Replacement Benefit Plan for a person who first becomes a member on or after January 1, 2013.

Background

Reciprocity

Reciprocity as it relates to public pension benefits, generally allows public employees to change employers without a loss of benefits. This portability of benefits may be limited in several ways, depending on the employer(s) and the retirement system(s) involved. A form of salary reciprocity exists for CalPERS members moving between public employers in CalPERS-covered service, including the State, schools and contracting agencies, whereby the member's highest compensation earnable for either CalPERS employer is used to calculate his or her retirement benefit. However, there are no other qualifications, such as continuous employment, etc., that apply.

Impacts of Salary Reciprocity on CalPERS Employers

Liabilities to cover the cost of benefits paid to members for service with multiple CalPERS employers is calculated when the actuarial office performs its annual valuations of each employer's plan. This is considered "transferred members' liability" that is shared among the member's current and former employers through changes in their annual contribution rates. Collecting contributions to cover transferred members' liability throughout their career benefits employers because CalPERS is able to invest those contributions and generate earnings to lower the overall retirement benefit liabilities of CalPERS employers.

Impacts of Salary Reciprocity on Risk Pools

CalPERS contracting agencies that have less than 100 members subject to a particular benefit formula, are required to participate in a risk pool. Under risk pooling, benefit package levels and asset experience—investment gains and losses—are allocated on the overall liabilities and assets attributable to each employer. Other risks are then spread among the members of the pool for everything else that has an impact on contribution rates, both for items not within the control of the pooled agencies such as mortality, as well as salary experience for active members, which is under an agency's control. Nevertheless, a pooled agency's absolute liability associated with its salary experience may be slightly larger because its actual payroll has increased.

Reciprocity with Other Retirement Systems

Existing law allows CalPERS to enter into agreements with other California public retirement systems permitting members to move from employment covered by one retirement system to the other without loss of benefits. Currently, if a member qualifies for reciprocity, his or her highest final compensation from either system can be used to calculate their retirement benefit, but the member will receive separate retirement payments from each system.

The liability caused by salary reciprocity between CalPERS and reciprocal retirement systems cannot be valued until the time of retirement. It is at the time an inactive member applies for retirement that CalPERS is informed whether he or she has been performing creditable work for a reciprocal system. When a member qualifies for reciprocity, CalPERS gathers the final compensation calculation of the reciprocal system to identify which of the member's final compensation figures is higher.

Federal Internal Revenue Code Limits

IRC Section 415(b) places a dollar limit on the annual benefit that can be received from a tax-qualified pension plan such as CalPERS. Under Section 415(b), the maximum annual retirement benefit payable at Social Security (normal retirement age) is $195,000 for calendar year 2011. This annual benefit limit may be adjusted by the Internal Revenue Service (IRS) annually to reflect changes in the cost of living. Determination of whether a member's retirement benefit will be subject to the 415(b) limit is made at retirement as the benefit limit is lower for members that retire before normal retirement age.

Some "grandfathered" members are not subject to the 415(b) limitation and can receive their full benefits. They include persons who were members of CalPERS prior to January 1, 1990; and persons for whom the employer has provided no new or enhanced benefits since October 14, 1987 (e.g. one year instead of three-year final compensation). However, if the employer has made a change in benefits since October 14, 1987, any increase in the allowance due to the enhanced benefit is not included in the "grandfathered" benefit, and is subject to the benefit limits.

IRC Section 401(a)(17) limits the amount of annual compensation that can be used to compute a retirement benefit under qualified retirement plans such as CalPERS. The compensation limit does not limit the salary payable to an employee by his or her employer. Rather, it limits the amount of compensation taken into account under the retirement plan and applies to retirement system employees who were first hired on or after July 1, 1996. The compensation limit for the 2011 calendar year is $245,000.

CalPERS Replacement Benefit Plan

Under the Public Employees' Retirement Law (PERL), retirees whose defined benefit allowances are determined to be limited under Section 415(b) will receive their entire retirement entitlement. The annual total benefit that exceeds their individual Section 415(b) limit is issued in quarterly payments as "replacement benefits" from a separate fund through the CalPERS Replacement Benefit Plan (RBP) funded by the employer. CalPERS invoices and collects the replacement benefit amount from the affected employer and disburses it to affected CalPERS retirees as wages. Several other public retirement systems in California administer similar replacement benefit programs.

Proposed Changes

Specifically, AB 1184 would:

- Provide that the obligations for retirement benefits that are attributable to excess compensation earned by a non-represented employee who was employed by one or more public agencies shall be the sole obligation of the subsequent contracting agency that paid the excess compensation.
- Define "excess compensation" as the final compensation of an employee of a contracting agency who previously worked for another contracting agency to the extent the final compensation received from the current contracting agency is in excess of 115 percent of the salary paid by the prior contracting agency, as adjusted for actuarial increases in that salary.
- Require the actuary, in determining contributions required of contracting agencies establish a contribution with respect to excessive compensation separate from and independent of the contribution required for other benefits under their contracts.
- Specify that the total contribution for the agencies as a group shall be established and from time to time adjusted by actuarial valuation performed by the actuary of the liability for the benefit or benefits on account of the employees of all those agencies.
- Provide that adjustments shall affect only future contributions and shall take into account the difference between contributions on hand and the amount required to fund the allowances or benefits for which entitlement has already been established, as well as liability for future entitlements to benefits.
- Provide that the contribution as so established and adjusted from time to time shall be allocated between the agencies on a basis that, in the opinion of the board, after recommendation of the actuary, provides an equitable distribution between the agencies as required by this section. However, the allocation shall not be based on differences in the incidence of death or disability in the respective agencies.
- Provide that when the board establishes a separate contribution, it shall maintain the contribution and any contributions required to be made by employees towards the cost of the benefit or benefits as a separate account, which shall be available only for payment of the benefit or benefits and shall not be a part of the accumulated contributions under this system of any of the employers or members included.

- Specify that all contributions in that account, irrespective of the agency from which they were received, shall be available for payment of the benefit or benefits with respect to the employees of any agency included.
- Prohibit the Board from administering an IRC Section 415 Replacement Benefit Plan for a person that first becomes a member on or after January 1, 2013.

Legislative History

2010 AB 192 (Gatto) – Would have required the contracting agency from which a non-represented CalPERS member retires, or otherwise has his or her final compensation calculated, to pay that portion of the liability for creditable service performed for a prior contracting agency that exceeds 115 percent of the last salary paid by that agency, as adjusted for actuarially assumed salary increases. *CalPERS Position: None*

AB 194 (Torrico) – Would have specified that, for the purpose of determining the retirement benefit payable to a member of a public retirement system first hired on or after January 1, 2011, the maximum salary shall not exceed 125 percent of the salary recommended by the California Citizen's Compensation Commission to be paid to the Governor. It would also have provided for yearly adjustments to this amount based on the All Urban California Consumer Price Index. *CalPERS Position: None*

Issues

1. Arguments on Support

According to the Author:

"This bill would save the taxpayers of well-run cities from having to pay the pension costs associated with exorbitant salaries in other cities. Additionally this bill would prohibit California's public employee retirement systems from participating in any program offering pension benefits in excess of the federal cap."

Support: *American Federation of State, County and Municipal Employees; Association of Los Angeles Deputy Sheriffs; California Professional Firefighters; California School Employees Association; Los Angeles County Probation Officers Union; Riverside Sheriffs' Association; and Service Employees International Union.*

2. Arguments by those in Opposition

According to the Association of California Water Agencies:

"AB 1184 is too broad and casts too wide a net. Reciprocity exists to allow labor mobility among employees and to pool the liabilities of the government employers involved in the retirement system. Doing away with the policy of reciprocity as we know it could have many unintended consequences. One such consequence could be that older workers with decades of experience would be punished and forced to stay at their current place of employment lest they violate the 15 percent rule. Additionally, an older worker who holds a trade's position and decides to return to school in order to receive a higher degree in hopes of landing a better position could also be punished for their experience. Essentially, AB 1184 could have the unintended consequence of enacting a form of age discrimination."

Opposition: *Association of California Water Agencies*

3. Limited Application Among CalPERS Employers and Employees

When it comes to determining whether an employer has paid an employee “excessive compensation”, the definition does not apply equally to all public employers and employees. This provision of the bill would only apply to a contracting agency within the CalPERS system that hires a non-represented employee and pays that employee “excessive compensation”. Therefore it would not apply to State agencies, school districts within the school pool, and public agencies participating in other retirement systems. To further complicate application, not all non-represented positions are the same among contracting agencies, especially in small cities and special districts.

This difference in application among employers and positions creates ambiguity and administrative complexity, and could result in unintended consequences. For example, not only will staff need to be able to track, determine, and calculate the application of this provision when employees move between multiple employers, both within and outside the CalPERS system, and non-represented and represented positions, but it is unclear how to apply this provision in these multiple scenarios. Also, as the Association of California Water Agencies pointed out above it could have an impact of an employer’s hiring decisions.

4. <u>“Excess Compensation” Contracting Agencies Will Assume Liability for Prior Contracting Agencies’ Benefit Enhancements and Special Compensation Payments</u>

According to the author, “This bill would save the taxpayers of well-run cities from having to pay the pension costs associated with exorbitant salaries in other cities.” Last year, he authored AB 192, whose provisions were substantially similar to AB 1184, in response to media reports that the City of Bell, a CalPERS contracting agency, had paid its top executives what was characterized as excessive salary and compensation. In one instance, the City hired a former police chief for the City of Glendale, another CalPERS contracting agency, and approximately doubled his compensation.

Under the PERL, Bell’s pension liabilities are limited to the chief's creditable service in their employ based on his compensation. Salary reciprocity also caused the pension liabilities for the chief’s other prior CalPERS-covered service to increase, which resulted in the employer contribution rates for his former CalPERS employers, or the employer risk pools to which they belong, to increase. However, such increases resulting from an individual member moving between CalPERS contracting agencies is very small as a percentage of the employer’s total member payroll, generally in the thousandths of a percent of employer payroll.

The remuneration of most public employees is not limited only to salary, but also includes allowances, stipends, health, retirement and other benefits. This concept of “total compensation” is meant to encompass all the employer’s ongoing personnel costs, and holds that as one form of remuneration is reduced, another will generally be increased to compensate. So, while an employer may have forgone paying salary increases in order to enhance their employees’ retirement benefit formula, or pay the employee’s share of their required retirement contributions, another employer may instead provide higher salaries and lower retirement benefits.

While the experience of the City of Bell represents an extreme example, when the total remuneration provided to an employee moving from public employer to employer in an equivalent position is similar, or an employee leaves for a higher level position with greater responsibilities, it is difficult to characterize which is the “better run” and subject to more favorable treatment under the Public Employees’ Retirement Law (PERL).

5. Requires an "Apples to Oranges" Comparison of Compensation

   CalPERS retirement benefits are based on the benefit formula and final compensation provided by the employer, as well as a member's age at retirement. For purposes of calculating the "final compensation" of a member, the member's highest average compensation earnable (consisting of both salary and special compensation) averaged over a twelve or thirty-six month period is used. In some instances, a member's final compensation is based on service that was not their final twelve or thirty-six months of covered-employment, or even performed for their final employer.

   AB 1184 requires CalPERS to identify whether a member's final compensation exceeds 115 percent of the salary paid by each of his or her preceding contracting agency employers, adjusted for actuarial increases in that salary. Notwithstanding that the 115 percent figure is an arbitrary number by which to trigger the shift in liabilities from one contracting agency to another, comparing a member's salary to final compensation (salary and special compensation) is an apples to oranges test that increases the likelihood that a member's final contracting agency will be forced to pay the retirement liabilities of a prior contracting agency, even though the final compensation paid by both is the same or substantially similar. That likelihood increased to the extent that the member received a larger percentage of their final compensation in special compensation from the prior contracting agency.

6. Proposed Method of Assessing Liabilities and Accounting for Funds is Inconsistent with Existing CalPERS Practice

   It is unclear how the provisions regarding the shifting and accounting of liabilities were developed or the intent behind them. They do not represent CalPERS current methods for allocating assessing liabilities, the complications of shifting liabilities for pooled contracting agencies, nor do they appear desirable to accomplish the author's stated intent.

   Routing the contributions for "excessive compensation" from one employer's plan or pool to another may also create a tax issues. Shifting liabilities between employers participating in a federally tax qualified pension plan without violating federal law is an extremely complex and challenging task that, if executed incorrectly, can threaten the tax qualification status of the Public Employees Retirement Fund (PERF).

As currently drafted, AB 1184 could potentially raise a tax issue if it were read to create a separate fund for certain contributions. This is not an instance where it clearly creates a tax problem; rather, this is a case where the language is sufficiently unclear that it is possible there will become a tax issue.

Furthermore, AB 1184 specifies that the “excess portion” of the member’s benefit is “the sole responsibility of the contracting agency.” It is not clear if this means that the contracting agency is solely responsible to CalPERS for contributions, or solely responsible to the retiree for the benefit. In other words, if the contracting agency was insolvent or merged with another public entity, is it unclear whether the statute would require CalPERS to actually cutback the benefit, which may impair the member’s vested rights, or just have the prior contracting agency contribute more to CalPERS to cover the cost of the benefit. If these will be established contribution obligations between the various employers, then the risks to CalPERS increase as the bill explicitly relieves the prior contracting agency of any liability for the excess portion of a benefit, but does not relieve CalPERS of such liability.

An alternative would be to require CalPERS actuaries to determine the correct liabilities within the bill’s definitions and require the contracting agency paying the “excessive compensation” to directly reimburse the other contracting agency outside the PERF. This greatly reduces CalPERS administrative costs associated with establishing, maintaining and auditing these additional accounts, and also eliminates the threat to the tax qualification status of the PERF.

7. <u>Potential Impact to the Pension System Resumption (PSR) Project</u>

   CalPERS is in the midst of implementing the PSR Project, a significant information technology effort involving all facets of CalPERS operations. The project is currently scheduled for implementation September 19, 2011 and incorporating any new legislation into the scope of the project at this time would not be possible without delaying the current launch date. Delaying the launch date has significant financial implications to CalPERS and our vendor in excess of one million dollars per week, in addition to the complexities of re-planning a new launch date internally and externally. The earliest that CalPERS staff could attempt to implement this large program change would be until January 2014, otherwise the administrative costs that will be borne by CalPERS contracting agencies will run into the tens of millions of dollars.

8. Impact of Closing the Replacement Benefit Plan (RBP)

   AB 1184 will also end CalPERS participation in providing replacement benefits to public employees that first become CalPERS members on or after January 1, 2013. Federal law limits the benefits an individual may receive from a defined benefit plan. The dollar limit for 2011 is $195,000. The law was enacted to prevent highly compensated individuals from using pension plans as tax shelters by paying high pension benefits as a substitute for high salaries. Contrary to the author's statements that AB 1184 would prohibit public employee retirement systems from providing pension benefits to future members in excess of the IRC Section 415(b) limit, the bill only has such an impact on CalPERS, and no other public retirement systems that provide similar replacement benefits to their members.

   Approximately 15 percent of all active CalPERS members were members of the plan prior to 1/1/90 and therefore, do not have their compensation limited and have their benefit amount grandfathered. Approximately 15 percent of all active CalPERS members became members of the plan between 1/1/90 and 6/30/96, and therefore, have their benefit amount limited, but do not have their compensation limited. The remaining 70 percent of all active CalPERS members are subject to both the benefit and compensation limits.

   The RBP provides a safe harbor should CalPERS mistakenly pay a member regular pension benefits in excess of the annual benefit limit and in violation of federal law. Therefore, if the RBP were eliminated, staff would need to be more diligent in the administration of this program to ensure compliance with the IRC 415 limits.

9. Legislative Policy Standards

   The Board's Legislative Policy Standards recommend an oppose position on proposals that create unreasonable cost or complexity for the administration of the System. While the author's intent has merit, the proposal itself would be difficult and costly for CalPERS to administer, and would subject a member's final contracting agency to a substantial portion of the employer liability associated with service performed for other contracting agencies and their prior benefit enhancements. Therefore, staff recommends the Board **oppose** AB 1184, unless it is amended to only eliminate the Replacement Benefits Program for new CalPERS members.

V. STRATEGIC PLAN:

This item is not a specific product of the Annual or Strategic Plans but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

Program Costs

The provisions of AB 1184 that relate to shifting liability among CalPERS contracting agencies does not increase benefit costs for CalPERS employers as a group, but will increase or reduce benefit costs for individually affected contracting agencies.

CalPERS employers will no longer be responsible for paying the cost of replacement benefits to “make whole” the retirement allowances of future members that are limited by IRC Section 415(b).

Administrative Costs

AB 1184 would result in substantial implementation costs to build in the necessary functionality into PSR that would allow staff to determine whether a contracting agency had paid “excessive compensation” to a member as specified in the bill, as well as moderate on going administrative costs to perform the necessary tracking, calculating and accounting of liabilities that could move between the approximate 1500 contracting agencies.

Eliminating the RBP would result in a minimal reduction of CalPERS administrative workload.

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